

Recycle your debt

It's now quite normal to be in debt up to your eyeballs and not even think twice about it. After all, everyone is in the same boat these days, what with the mortgage, the credit cards, and the car finance... aren't they?

Statistics tell us that Australia's total household debt now stands at \$650 billion, that's about \$32,500 for every Australian (source: www.rba.gov.au). While these are worrying figures, getting into debt isn't always a bad thing. One way to improve your financial position is to recycle your debt, from bad to good. Here is an explanation of how you can get debt to work for you.

Pay off your property

A mortgage on your home is generally considered a good debt, as you have a tangible investment (asset) and somewhere to live. However, it is still a large debt, and the sooner you pay it off the less you will pay. What's more, interest on a home loan is non-deductible, i.e. there are no tax advantages.

Early repayment of your home loan e.g. by making extra payments, may save you thousands of dollars off the overall cost of the loan. While this is all very well in theory, if you're stretched to the max making mortgage repayments, how will you find the money to make the extra payments?

Make money from recycled debt

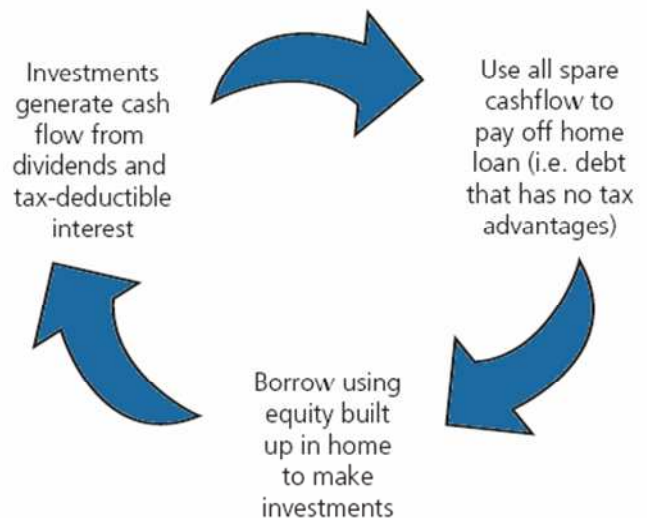
If you have equity in your home or other assets you can borrow against the value of these to purchase investments such as managed funds. The interest charged on these types of loans is tax deductible. This strategy is commonly called gearing and can help with reducing tax and generating investment income.

Recycle your investment income

Any cash dividends that you receive from managed funds and other investments can be recycled into paying off non-deductible debt like your home loan. Every day we take in vast amounts of information although retain only a small proportion of it. This retention issue also applies to how much we absorb about the share market and shares in general.

Recycle your tax savings

The interest on investment loans is taxdeductible (as long as you use the loan to earn assessable income on investments). Once you've received your tax deduction, you can recycle it by making extra payments on your home loan. Please note there is risk involved in borrowing against your home and risk associated with investing. Therefore, it is very important to consult your wealth adviser prior to making any financial decisions. The diagram below provides an example of how you can recycle your debt.



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If you decide to gear your assets (borrow to invest), you will need to consider the type of loan and debt structure that will suit you best, based on your personal circumstances. Here are a few options.

Equity loans

An equity loan is a line of credit secured by the mortgage on your home. It allows you to borrow against the equity you have built up in your home to make further investments, which will generally rise in value and provide income. As long as you stay within your limit, you can pay back the loan when you want to. Credit limits for equity loans are generally higher than for personal loans, while interest rates are usually lower. If you repay the outstanding balance, you can redraw on your limit without re-applying. Once you have been approved for a loan and made an investment, it's up to you to monitor your investments and the implications for your tax position. Again, consulting your wealth adviser is strongly recommended.

Recycle debt with regular investments

One way of using your equity loan is to make monthly draw downs on the loan and use that money to invest into managed funds. Regular investments can help with dollar-cost averaging (i.e. averaging out the effect of rising and falling prices), which will give you a better return over the long term.

Recycle debt with a margin loan

Another strategy (most effective for those on the highest marginal tax rate) is to have two debts – one in which the interest is not tax deductible, e.g. a home loan, and the other where the interest is tax deductible, e.g. an investment or margin loan. The strategy involves using the income from the investment/margin loan and other spare cash flow to repay the home loan, then making interest-only payments on the investment or margin loan. The non-deductible debt (the home loan) will be paid off faster while the deductible debt (the investment/margin loan) will stay the same. The interest on the investment/margin loan should be fully tax deductible.

Why pay off non-deductible debt first?

As the interest on a home loan is not tax deductible it has a significantly higher before-tax cost than deductible debt (your equity loan or margin loan). For example, for those on the highest marginal tax rate, the actual cost of non-deductible debt with an interest rate of 7% is 13.59% after tax, whereas the cost of deductible debt is the actual interest rate, i.e. 7%.

Structuring debt is complex and may result in financial loss. We recommend you seek professional advice before putting in place any debt recycling strategies.